FEDERAL INSURANCE OF PRIVATE PENSION BENEFITS

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NOTES

Unless otherwise stated, all years referred to in this paper are fiscal years.

Details in the text and tables of this paper may not add to totals because of rounding.

PREFACE

As part of a broader effort to protect and enhance workers' pension benefits, the Congress in 1974 created a federal program of private pension insurance to be operated by the Pension Benefit Guaranty Corporation. This program has incurred some large claims in recent years, raising questions about several aspects of its operation and about its future financial status. This paper was prepared by the Congressional Budget Office (CBO) at the request of the Subcommittee on Oversight of the House Committee on Ways and Means. It analyzes the pension insurance program and considers issues affecting its future direction. Options that address these issues also are examined. In accordance with CBO's mandate to provide objective and impartial analysis, this paper contains no recommendations.

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SUMMARY

In 1974, as part of a broader effort to protect participants in private pension plans, the Congress created a federal program of pension insurance to be operated by the Pension Benefit Guaranty Corporation (PBGC). The purpose of this agency is to ensure that workers receive certain retirement benefits promised by their employer, if their pension plan is terminated with insufficient assets to pay for these benefits.

Almost from the start, the pension insurance program for single-employer plans has had financial difficulties, and the PBGC itself has accumulated a large and growing deficit. In recent years, the Congress has responded to these and related issues by making changes in pension policies generally and by modifying the pension insurance program in particular. With the near tripling of the program's accumulated deficit during 1986 to $3.8 billion, however, concern has been expressed that additional changes are needed to assure the program's financial viability.

FEDERAL INSURANCE OF PRIVATE PENSION BENEFITS

Employers need not provide pensions for their workers, but if they do, the federal government requires them to follow rules relating to most major aspects of the plan's operation. In particular, an employer who sponsors a so-called defined-benefit pension plan--one that promises a specified annual pension benefit in retirement rather than simply providing contributions to workers' retirement accounts--is required to contribute at least a minimum annual amount to that plan as benefit commitments accrue. Annual payments must be sufficient to cover the normal cost of benefits accrued by workers in that year, as well as a portion of other liabilities that usually can be amortized over periods of 15 years or 30 years.

Even if they satisfy all legal funding obligations, pension plans can be underfunded if they terminate, largely because of the time involved in amortizing certain liabilities. These liabilities include obligations that result when pension benefits are granted for service before the plan began, and when the plan is amended to increase or extend benefits. They can also arise from unexpected changes in other factors, such as the early retirement of large numbers of workers or the poor investment performance of the plan's assets.

While the federal government does not restrict the termination of sufficiently funded pensions, those with funding shortfalls can be terminated only if the sponsor of the plan is in bankruptcy proceedings or generally would be unable to pay its debts without the termination. Once an underfunded plan is terminated, the PBGC takes over all of its assets, assumes liability for all guaranteed benefits, and attempts to recover any remaining liability of the sponsor. Since 1975, almost 75,000 single-employer defined-benefit pensions have terminated, with about 1,345 of those--or less than 2 percent--containing some unfunded benefits that were then taken over by the PBGC. Funds to pay for this insurance protection are derived from an annual premium of $8.50 for each pension participant, plus resources from terminated underfunded plans and their sponsors.

Because guaranteed benefits are limited in a number of ways, benefits paid by the PBGC to participants in terminated underfunded plans can be less than the amount they would have received had their plan not terminated. Only benefits vested before the plan is terminated are guaranteed by the PBGC, for example, and those benefits are not fully guaranteed unless they have been a part of the pension agreement for at least five years. Maximum guaranteed monthly benefits are limited to an indexed amount that is currently $1,858 for a life annuity beginning at the normal retirement age. The guarantee also applies to the nominal dollar benefit of the plan. Benefits are not protected against inflation that occurs either between the years the plan terminated and the workers retired, or after retirement.

The Financial Status of the PBGC

By the end of 1986, the PBGC had accumulated a deficit of $3.8 billion, largely because a few severely underfunded pension plans had terminated in 1985 and 1986 (see Summary Table 1). 1/ This shortfall is the difference between assets of about $3.6 billion and the present value of liabilities of

1. The "accumulated deficit" of the program refers to the unfunded portion of the PBGC's liabilities that have been generated since the program began in 1974, and not to the annual change in this shortfall.

   Part of this deficit is now being contested in Bankruptcy Court and U.S. District Court. On September 22, 1987, the PBGC notified the LTV Corporation that it was restoring to that company three large underfunded pension plans that previously had been terminated and placed under the trusteeship of the PBGC. If successful, this action would reduce the PBGC's accumulated deficit by about $2 billion.

SUMMARY TABLE 1. THE FINANCIAL STATUS OF THE PBGC
(In millions of dollars)

Program Experience During 1985 and 1986

	1985	1986
Premium Income	82	201
Investment and Other Income	129	262
Benefits Paid	170	261
Number of Participants Receiving Benefits	74,800	90,750
Number of Underfunded Plans Terminated	77	103
Annual Addition to the Accumulated Program Deficit	863	2,501

Cumulative Program Experience, 1974-1986

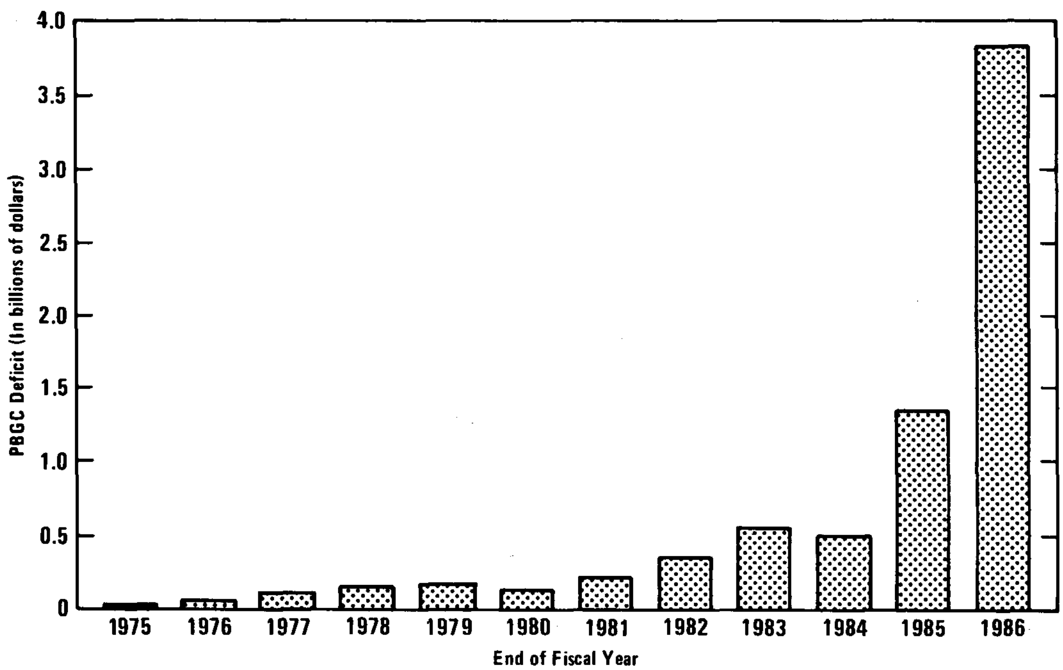
Number of Underfunded Plans Terminated	1,345
Number of Participants Owed Current or Future Benefits	355,000
Assets	3,600
Liabilities	7,400
Accumulated Program Deficit	3,800

SOURCE: Congressional Budget Office using data from Pension Benefit Guaranty Corporation, *Annual Report*, 1986.

about $7.4 billion. The present value of liabilities represents the amount of money that would be needed today to purchase annuities sufficient to pay, when due, all current and future benefits for which the PBGC has already accepted responsibility. Annual additions to the accumulated program deficit were about $860 million in 1985 and $2.5 billion in 1986. As displayed in the Summary Figure, this accumulated deficit has grown during all but two years since the program began.

A large part of the dollar value of claims against the PBGC has been made by a very small number of plans (see Summary Table 2). For example, of the 1,345 underfunded pension plans terminating since 1975, the eight plans with the largest levels of unfunded benefits accounted for about two-thirds of the dollar value of all claims. Fully 87 percent of claims for unfunded benefits were made by the 3 percent of all terminating underfunded plans with the largest unfunded liabilities. Moreover, terminated pensions in the steel industry alone amounted to about 80 percent of all claims.

Summary Figure.
Accumulated Deficit of the Pension Benefit Guaranty Corporation, 1975—1986



SOURCE: Congressional Budget Office using data from Pension Benefit Guaranty Corporation, *Annual Report,* various years.

Prospects for the PBGC's Financial Status

The future financial condition of the pension insurance program is highly uncertain because it will depend largely on how many private pension plans terminate and on the amount of underfunding in those plans. Both factors are hard to forecast accurately. Moreover, a few pension plans with extremely large unfunded liabilities have dominated PBGC's past claims, and its future may likewise depend significantly on the fate of a few large plans,

SUMMARY TABLE 2. DISTRIBUTION OF NET CLAIMS AGAINST THE PBGC, FISCAL YEARS 1975-1986

Category of Claim (By size of claim, in millions of current dollars)	Number of Plans Making Claims	Net Claims in Category: In millions of current dollars	Net Claims in Category: As a percentage of total net claims
Greater than 100	8	2,636	68
50-100	1	55	1
25-50	12	416	11
10-25	19	295	8
5-10	22	159	4
1-5	107	228	6
Less than 1	1,176	111	3
Total	1,345	3,900	100

SOURCE: Congressional Budget Office calculations based on data from Pension Benefit Guaranty Corporation, *Annual Report*, 1986.

NOTE: Data reflect the amount of the claim on the date the pension plan was terminated.

making liabilities even more difficult to predict. Future terminations will probably be influenced by overall economic conditions, by the prosperity of particular industries, by competition from abroad, and by a variety of factors that are specific to particular firms--such as their competitive position in the industry, their agreements with labor groups, and the assessments of their financial prospects that are necessary for them to obtain credit.

Using the historical experience of the PBGC as an indicator of future claims, for example, the annual premium would need to rise to roughly $25 per participant in 1988 if premium revenue alone was used to finance the program's operation. This calculation assumes that the accumulated deficit will be repaid over the next 15 years, and that both the premium and future claims will grow with average wages. Because of the large degree of uncertainty in predicting future insurance claims, however, reasonable estimates of the PBGC's future revenue needs can vary widely. Ignoring potential future claims, the existing accumulated deficit of $3.8 billion could be repaid with a one-time charge of about $120 per insured participant.

CURRENT ISSUES

The accelerated decline in the PBGC's financial position has focused concern on several issues, including whether or not the program needs corrective actions, the types of benefits that should be insured, and who should pay for the insurance protection.

Are Changes in the Pension Insurance Program Needed?

Changes in the pension insurance program may or may not be needed, depending on how its past experiences are interpreted and on how its financial prospects are assessed.

Recent financial problems may be symptomatic of difficulties in pension policies generally and in the design of the insurance program in particular. For instance, funding rules for pensions may be inadequate to ensure that plans will be sufficiently funded. Moreover, the existing premium structure does not necessarily promote the full funding of pensions. Financial difficulties for the PBGC may also continue if the degree of structural change in the economy does not lessen appreciably in future years, and if the economic conditions that gave rise to the termination of underfunded pensions in the past continue to exist.

On the other hand, little or no change in the program may be required. One cause of the PBGC's difficulties has been the unusually hard economic times faced by firms in certain declining industries, and the severity of these dislocations may not persist in the future. Moreover, because claims against the PBGC have stemmed in large part from the financial problems of only a very few pension plans, current difficulties do not necessarily represent a broader trend for the future. Finally, the tremendous uncertainty about the future financial condition of the agency, combined with the fact that it does not now have immediate unmet cash needs, might argue for delaying any changes until it is absolutely clear that they are needed.

What Types of Benefits Should be Insured?

Proposals also have been made to reconsider the nature of the insurance protection provided by the PBGC. In particular, one issue is whether the government should continue to insure pension benefits that have not been fully funded at least at some time in the past, usually because certain pension costs were amortized over several years. The basic argument for denying insurance protection for underfunded benefits is that insuring them goes well beyond the traditional protection provided by government in other areas, such as in insuring bank deposits. Yet the government's own rules are often the source of underfunding. Current federal rules and accepted actuarial principles allow sponsors to spread their pension costs over many years, thereby raising the likelihood that the PBGC will be called on to pay for some of these benefits.

Who Should Pay for Insurance Protection?

With recent growth in the cost of pension insurance--from $1 per participant in the original legislation in 1974, to $2.60 in 1978, and to $8.50 today--and with the prospect of considerably higher insurance premiums in the future, the issue of who should pay them becomes an increasingly important one.

The costs of pension insurance could be allocated in several ways. One method would continue to distribute costs equally among participants in all defined-benefit pension plans. This approach spreads program costs widely, but it includes many plans that have little likelihood of making a claim. Alternatively, insurance costs could be targeted on plans that are more likely to make a claim against the PBGC. This allocation would tie premium payments more closely to anticipated costs and would provide an incentive for participants and sponsors to raise the funding levels in their plans. It also could worsen the financial condition of sponsors of underfunded plans, however, thereby potentially making it more likely that those plans would be terminated and that claims would be made against the PBGC. Finally, costs could be distributed more broadly, possibly even to all taxpayers through the use of federal general revenue. Plans that continue in operation thus would be insulated from any financial difficulties caused by terminated plans, but this method might also be an inappropriate use of general tax revenue because only a portion of the population will ever benefit from private pensions.

POLICY ALTERNATIVES

A variety of options are available that would address the issues just discussed. Some options would reallocate costs among sponsors of plans. Others would alter existing rules about the funding of pensions and the termination of underfunded plans. Most of these options would indirectly improve the financial status of the PBGC, in some cases substantially. Alternatively, or in addition, changes could be made to raise revenue or reduce outlays directly.

Options for Reallocating Program Costs

One concern is that the annual premium paid on behalf of participants in plans is the same regardless of the insurance risk posed by their plans. Instead, a so-called variable-rate premium structure could be used, in which the premium charged on behalf of participants would vary among plans according to some measure of the risk that each plan represents to the PBGC.

If a variable-rate premium structure were adopted, it would have to include a basis for assessing premiums and might also specify maximum or minimum premiums to be charged. The assessment of the premium could be based on the level of unfunded benefits in the plan that are guaranteed by the PBGC (called the "exposure" of the PBGC for that plan), on the risk that the plan will terminate with a claim against the PBGC, or on both.

An upper limit, or cap, on the annual premium per participant would lessen the chances that the cost of the insurance itself would lead to financial difficulties for the sponsor or to termination of the plan. At the same time, however, it would limit the extent to which the insurance costs were allocated according to exposure or risk. A minimum premium that is greater than zero would allow certain program costs to be shared by participants in all covered plans, but might also somewhat lessen the incentive for sponsors to fund their plans fully.